<u>Own a Small Business or Considering One? 5 Basics to Know About Buy-Sell Agreements</u>

When starting a business, having a partner brings some obvious benefits over going it alone, but what happens if both individuals decide to eventual go their separate ways or one faces a life-altering event or death? A buy-sell agreement can plan for any of those happenings, among a long list of others. In general terms, a buy-sell agreement is an agreement between the owners of the business that, upon the occurrence of a triggering event, a departing owner will sell his interest in the business to the remaining owner based upon pre-determined terms. The benefits of buy-sell agreements are plentiful and with proper planning and consideration, they can be a valuable piece of a business owner's estate plan. Before jumping in head first, here are six things to know:

1) **There are two basic options to structure a buy-sell agreement**

There are two basic types of buy-sell agreements: 1) a cross-purchase agreement and 2) an entity purchase agreement. In a cross-purchase agreement the remaining business owner buys the departing owner's interest directly, and in an entity purchase agreement the business is the buyer of the departing owner's interest. There is a possibility that a sort of hybrid approach could be used where the remaining owner or owners purchase a portion of the departing owner's interest and the business purchases the remaining portion, though one of the direct purchase options above will be sufficient to accomplish the needs of a vast majority of small and mid-sized business owners.

2) **After determining structure, it is necessary to determine a purchase price.**

The valuation of a business interest needs to consider the value of any assets held by the business, goodwill, depreciation and even the accounting method used to conduct business operations. This is one of those situations where it would be worthwhile to call your accountant given the intricacies of valuing each item and the substantial options with which to do so. Very generally, the idea is to determine the value of the business and then apportion that value between the owners given their relative ownership interests. Possible options to consider are a net book value or net book value with adjustments approach, a multiple-of-earnings approach, a specifically stated value approach or a hybrid of those options. Once the method is determined, the means to go about the valuation must be considered- whether it is by an outside appraiser, or the owners themselves. Your attorney will be able to draft language that will reflect your desires and ensure that the valuation method agreed upon with your accountant is followed when the time comes for the buy-sell agreement to work its magic.

3) To insure or not to insure?

Given the relatively substantial size of most business interests there is always the possibility that an unforeseen event such as the death of one owner, for example, could bring down the entire business. Without a means to pay the loved ones of the deceased owner, the remaining owner or owners must face the choice between finding a way to pay the decedent's family an amount equal to his interest in the business, permit the decedent's family members to take his place in managing the business or wrap up the business entirely and use the proceeds to pay the decedent's family his portion. To avoid all of these harsh options, many times a viable and wise choice is for the business owners (or the company) to purchase life insurance policies on the life of each co-owner. The effect of this would be that if one owner dies, the remaining owner receives the life insurance proceeds on the decedent's life which can then be used to pay the surviving family members for the decedent's interest in the business. By following this route, the business will continue to be run by the remaining owners in its original form as their family of the deceased would have received the value of his interest upon his death.

4) A buy-sell agreement can guarantee continuity of management.

Buy-sell agreements provide for the continuity of management of the business without intervention or involvement from unwanted shareholders or partners. They also ensure that profits will not have to be shared with unwanted individuals. By determining how a departing owner or a deceased owner's family will be compensated the remaining owners can avoid any unnecessary arguments or actions to determine the value of an interest or how much management authority a decedent's loved ones should have as the business continues to operate.

5) Marital Property Considerations

In marital property states (like Wisconsin) it is important to determine and consider the classification of the interest in the business. Generally, a business interest acquired with marital property is the marital property of both spouses. Even if the business was originally founded with separate property, any additional funds or property subsequently put towards the business must be considered on their own properties. If there has been mixing of nonmarital and marital property then the interest will be considered a marital property interest and the burden will be on the departing owner or deceased owner's representative to trace the investments back to nonmarital property. However, in Wisconsin a spouse holding an interest in a business with a right to manage and control the interest may enter a buy-sell agreement with the other business owners which becomes binding on the non-owning spouse even if the business interest is or becomes marital property and the non-owning spouse does not sign the agreement. A word of caution, the outcome may differ if the non-owning spouse dies first. In such an instance, a marital property agreement or option to purchase may be a useful tool, however both are outside the scope of this post and it would be wise to consult an attorney to discuss these options.

Buy-sell agreements can be a valuable estate planning tool for business owners due to their ability to settle most disposition and management issues before they arise. As with any other estate planning device, there is no one-size-fits-all solution to what works best for everyone, but if you are a small business owner or are thinking about a startup, it may be wise to consider the benefits that a buy-sell agreement can bring to the table.

Michael F. Brennan runs a virtual law office helping clients in Illinois, Wisconsin, and Minnesota with estate planning. He can be reached at michael.brennan@mfblegal.com with questions or comments, or check out his website at www.thevirtualattorney.

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